

11 U.S.C. 365(b) (1)  
Lease vs. Security Agreement

In re Virgil and Betty Williams

696-62755-fra13

8/12/96

FRA

Unpublished

Debtors are lessees under a "personal property lease" entered into with Dolsen Leasing Company. The subject matter of the lease is a Volvo long-haul truck. In their Chapter 13 plan the debtors treated the obligation to Dolsen as a secured claim and proposed to cure the arrearage over the life of the plan. Dolsen claimed the lease is a true lease which would require the debtors to cure the default in payments promptly pursuant to § 365(b) (1) (a) if the debtors wished to retain possession of the truck.

The court examined Washington law (the law governing this lease agreement) as it existed at the time the agreement was entered into (UCC 2A has since been enacted). Under prior Washington law, courts were directed to examine the facts and circumstances of each agreement to determine whether it is a true lease or a security agreement. In holding that the agreement is in fact a true lease, the bankruptcy court stated that the two most important factors pointing to a true lease in this case are the fact that the lessee did not acquire any equity in the truck during the term of the lease and that the lessee could not purchase the truck at the end of the lease for a nominal amount (option price was approximate FMV).

E96-9(8)

1  
2  
3  
4  
5  
6  
7  
8 UNITED STATES BANKRUPTCY COURT  
9 FOR THE DISTRICT OF OREGON

10 In Re: ) Bankruptcy Case No.  
11 ) 696-62755-fra13  
12 Virgil R. Williams and )  
Betty L. Williams, )  
13 Debtors. ) MEMORANDUM OPINION

14 The issue in this case is whether a transaction between  
15 debtors and a creditor is a lease or a security agreement. For  
16 the reasons set out in this opinion, I hold that it is a lease.

17 I. BACKGROUND

18 Debtors are lessees under a "Personal Property Lease"  
19 entered into with Dolsen Leasing Company ("Dolsen") on February  
20 1, 1993. The subject matter of the lease is a 1993 Volvo long-  
21 haul truck.

22 Debtors have filed a petition for relief under chapter 13  
23 of the Bankruptcy Code. Their proposed plan treats the  
24 obligation to Dolsen as a secured claim, and proposes to cure an  
25 arrearage in payments over the life of the plan, and to continue  
26 monthly contract payments outside the plan. Dolsen claims the

1 lease is a "True lease" and moves for an order setting a time in  
2 which the debtors must assume or reject the lease. If the  
3 contract is a lease, as opposed to a security agreement, debtors  
4 will be required to cure their default in payments "promptly",  
5 rather than over the course of a Chapter 13 plan. Code  
6 § 365(b)(1)(a).

7 A hearing on the motion was held on August 6, 1996, and a  
8 copy of the lease and an addendum were placed into evidence. Mr.  
9 Williams testified that he had not read many parts of the lease,  
10 including the addendum, but that he believed he had entered into  
11 a "lease to buy" agreement. The addendum provides that the  
12 debtors may purchase the truck at the end of the lease (that is,  
13 after five years) for \$16,700. This sum was described in the  
14 addendum as "the closest approximation the parties can now make  
15 of the reasonable market value of the leased property at the  
16 expiration of the term of this lease." Mr. Williams testified  
17 that he now thinks the value at that time will be closer to  
18 \$10,000.

## 19 II. APPLICABLE LAW

20 This is a core proceeding. 28 U.S.C. § 157(b)(2)(M). The  
21 matter turns on whether the agreement is a lease or a security  
22 agreement. This is an issue of state law. In re Allen, 174 B.R.  
23 293, 295 (Bankr. D. Or. 1994).<sup>1</sup> By its terms the contract is

---

24  
25 <sup>1</sup>But see In re Moreggia & Sons, Inc., 852 F.2d 1179 (9th  
26 Cir. 1988). In Moreggia & Sons the Court had to determine  
whether the automatic rejection of a residential lease under Code  
(continued...)

1 governed by the laws of the State of Washington. At the time the  
2 contract was signed, Washington had not adopted Article 2A of the  
3 Uniform Commercial Code, on which Dolsen relies in its supporting  
4 memorandum. It is, therefore, necessary to examine the state of  
5 the law in Washington in February 1993.

6 The two Washington cases dealing with this issue up to  
7 that time are Courtwright Cattle Company v. The Dolsen Company,  
8 94 Wash. 2d 645, 619 P.2d 344 (1980), and Rainier National Bank  
9 v. Inland Machinery, Inc., 29 Wash. App. 725, 631 P.2d 389  
10 (1981). These cases, following All-States Leasing v. Ochs, 42  
11 Or. App. 319, 600 P.2d 899 (1979), hold that, in determining  
12 whether an agreement is a lease or security agreement

13 [T]he presence of certain factors can be  
14 indicative, including, but not limited to:  
15 (1) whether the lessee is given an option to  
16 purchase the equipment, and, if so, whether  
17 the option price is nominal... (2) whether the  
18 lessee acquires any equity in the equipment;  
19 (3) whether the lessee is required to bear  
20 the entire risk of loss; or (4) pay all  
21 charges and taxes imposed on ownership; (5)  
22 whether there is a provision for acceleration  
23 of rent payments, and (6) whether the  
24 property was purchased specifically for lease  
25 to this lessee.

20 \_\_\_\_\_  
21 <sup>1</sup>(...continued)  
22 §365(d)(4) applied to a particular transaction. The Court held  
23 that "the appropriate focus is on the federal law purposes of  
24 Section § 365(d)(4) and the economic realities of this particular  
25 arrangement." 852 F.2d at 1182.

26 Section 365(d)(4) is not at issue here, and therefore  
Moreggia & Sons is inapposite. In re SCCC Associates II Limited  
Partnership, 158 B.R. 1004, 1014 (Bankr. N. D. Calif. 1993).  
Moreover, analysis of the economic realities of the transaction  
is at the heart of the approach mandated by Washington law prior  
to the enactment of UCC Art. 2A. Either analytical approach  
leads to the same result in this case.

1 Courtwright, 619 P.2d at 349. In addition, the Rainier Bank  
2 court, citing to In re Alpha Creamery, Inc., 4 U.C.C.Rep. 794,  
3 798 (Bankr. W.D. Mich. 1967) notes four characteristics of a true  
4 lease: (a) a provision specifying a purchase option price which  
5 is approximately the market value of the equipment at the time of  
6 exercise of the option; (b) rental charges indicating an  
7 intention to compensate the lessor for loss of value over the  
8 term of the lease due to aging, wear and obsolescence; (c)  
9 rentals which are not excessive and an option purchase price  
10 which is not too low; and (d) facts showing that the lessee  
11 acquires no equity in the leased property during the term of the  
12 lease.

13 Dolsen asserts that the case is controlled by Article 2A  
14 of the UCC, which was adopted in Washington in 1993, but after  
15 this contract had been signed. They argue that the UCC simply  
16 codified or "clarified" existing Washington law, and that, for  
17 that reason, it is now controlling. The argument rests on In re  
18 Baumgardner, 183 B.R. 224 (Bankr. D. Idaho 1995). In Baumgardner  
19 Judge Hagan held that the enactment of Article 2A by the Idaho  
20 Legislature clarified, but did not change, Idaho law. That may  
21 be: however, there are significant differences between the  
22 "bright line" test set out in Article 2A and the rule set out by  
23 the Washington Courts in Courtwright and Rainier Bank. The UCC  
24 now provides that a transaction creates a security interest if  
25 the consideration paid for the right to possession is an  
26 obligation for the term of the lease, and not subject to

1 termination by the lessee, and any one of four additional  
2 criteria are met. RCW 62A.1-210(37). Courtwright and Rainier  
3 Bank, on the other hand, list a number of "indicative" factors,  
4 and require a case by case determination based on those factors.

### 5 III. ANALYSIS

#### 6 1. *Option to Purchase*

7 *Former* RCW 62A.1-201(37)(b) provided that "an agreement  
8 that upon compliance with the terms of the lease the lessee shall  
9 become the owner of the property for no additional consideration  
10 or for a nominal consideration does make the lease one intended  
11 for security." If this criterion is met, the lease is a security  
12 agreement as a matter of law, and the inquiry ends here.

13 The addendum provides that the debtors have the right to  
14 purchase the truck at the end of the lease. The question is  
15 whether the \$16,700 purchase price is nominal. Washington's  
16 courts have noted that amounts up to 25% of the property's market  
17 value at the end of the lease should be considered "nominal."  
18 Courtwright, 610 P.2d 344, 350. Here, according to the terms of  
19 the contract, the consideration will be roughly 100% of the  
20 actual value. If Mr. William's estimate is correct, the price  
21 will be over 100%. The consideration is not nominal.

#### 22 2. *Equity*

23 Equity arises where the lessee acquires an enforceable  
24 ownership interest in the collateral. Rainier National Bank v.  
25 Inland Machinery, Inc., 29 Wash. App. 725, 631 P.2d 389, 394  
26 (1981). This may occur when lease payments are credited towards

1 the purchase price. *Id.*

2       This contract does not create any equity in the property.  
3 The addendum states that rent payments are not to be credited  
4 toward that purchase. The delivery of a cash security deposit  
5 does not create an equity in the truck, especially in light of  
6 this provision in the addendum. The lessees would not acquire  
7 any ownership interest until and unless the option price was  
8 paid.

9 3. *Risk of Loss*

10       Risk of loss is assumed by the lessees.

11 4. *Charges and taxes*

12       All such costs are to be borne by the lessees. Lessees  
13 are also required to pay for required maintenance: "It is  
14 understood that this is a net lease and Lessor assumes no  
15 obligation whatsoever of the maintenance, repair or replacement  
16 of the leased property or any portion thereof." (Lease, Par.  
17 8.1).

18 5. *Acceleration*

19       All payments due under the lease are immediately due and  
20 payable in the event of an act of default.

21 6. *Property acquired by Lessor for this lease*

22       The lease states that the truck was selected by the  
23 Lessees, and that lessor has made no representation regarding its  
24 condition or fitness.

25       All things considered, I believe the transaction in this  
26 case is a true lease. The most important criteria for finding a

1 security agreement are the right to purchase for a nominal price  
2 and the acquisition of equity during the course of the lease.  
3 Neither element is present here. Risk of loss, payment of  
4 charges, insurance requirements and similar provisions are  
5 important; however, costs of this sort are commonly passed along  
6 to a lessee in true leases as well, either by the terms of the  
7 lease or by way of increased rent. Rainier Bank, at 395. The  
8 fact that the truck was acquired for the purposes of this lease  
9 may be significant, but does not outweigh the other factors.

#### 10 IV. BANKRUPTCY IMPLICATIONS

11 Since the transaction is an unexpired lease, it must be  
12 assumed or rejected by the debtors. Code § 363. The court may  
13 set a time limit in which such election must be made, after  
14 motion, notice and a hearing. FRBP 6006.

15 Debtors' arrearage under the lease is approximately  
16 \$18,000. In order to assume the lease debtors must pay this  
17 amount, or give assurance of prompt payment after assumption.  
18 Code § 365(b)(1). The lease may be assigned to a third party if  
19 cured. Code § 365(f)(2). Until such time as the lease is  
20 assumed or rejected, the debtors must continue making lease  
21 payments and otherwise perform under the agreement. § 365(d)(3).  
22 And, of course, Debtors have to get a plan of reorganization  
23 confirmed if they intend to remain in Chapter 13. Since their  
24 treatment of the agreement with Dolsen presumes that it is a  
25 security agreement, it will be necessary to submit an amended  
26 plan. Debtors cannot be expected to assume the lease as part of



1 a plan of reorganization without knowing whether the plan will be  
2 confirmed. It follows that the deadline to assume or reject the  
3 lease should be on or before the date the plan is confirmed.  
4 Although the lessor is protected by the continued lease payments  
5 in the mean time, there should also be a final deadline in case  
6 there is a delay in confirming the plan, or the case is  
7 converted. The deadline shall be the earlier of 10 days after an  
8 order of confirmation is entered, or November 1, 1996.

9 An order consistent with the forgoing will be entered.  
10 This memorandum opinion contains the court's findings of fact and  
11 conclusions of law, which will not be separately stated. FRBP  
12 7052.

13  
14  
15 FRANK R. ALLEY, III  
16 Bankruptcy Judge  
17  
18

19 cc: Keith Boyd  
20 Frank Rote  
21 Ron Becker  
22  
23  
24  
25  
26